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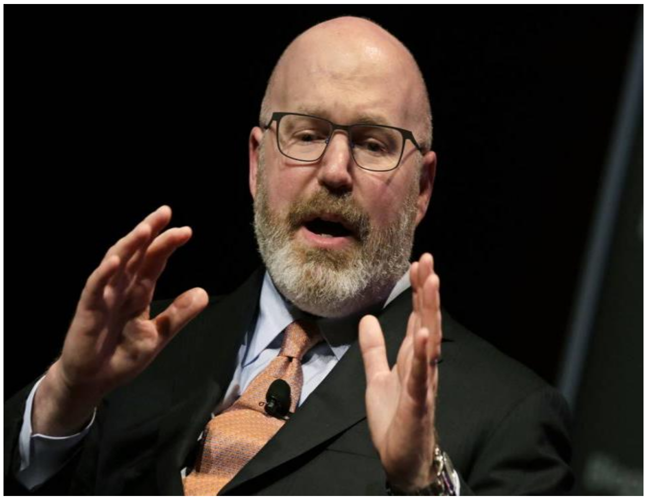
Investors Pull Cash From Hedge Funds as Returns Lag Market

In last quarter of 2015, more money was withdrawn from hedge funds than was taken in Updated March 30, 2016 3:00 p.m. ET



'There is stuff still out there sold as magic, but there are simpler, cheaper options that accomplish much of the same thing,' says hedge-fund manager Clifford Asness of AQR Capital, which offers lower-cost alternatives. *PHOTO: PETER FOLEY/BLOOMBERG NEWS*

Marc Levine, chairman of the $16 billion Illinois State Board of Investment, had a provocative question this month during a board meeting about hedge funds.

"Why do I need you?" Mr. Levine asked. A lot of big investors are asking the same question.

Pension funds, insurers and university endowments helped pump up hedge funds to a record $3 trillion in assets over the last decade. But with results falling behind a more traditional mix of stocks and bonds for six straight years and the high-fee structure now politically sensitive in some states due to uneven results, many of them are pulling back.

From New Mexico to New York, big investors are dramatically reducing their commitments and opting for cheaper imitations. Investors globally asked for more money back from hedge funds than they contributed in the fourth quarter of 2015, according to HFR Inc.—the first net quarterly withdrawal in four years. They pulled an additional $15.3 billion in this year's first two months, according to eVestment.

The exodus will soon include the Illinois fund overseen by Mr. Levine. Two days after he questioned whether hedge funds were necessary, the board that oversees investments for about 64,000 public employees agreed to yank $1 billion from them in favor of bigger bets on private-equity and low-cost stock funds. One of the investments that Illinois exited from, Mr. Levine said, includes exposure to hedge fund Pershing Square Capital. The New York fund was down more than 20% through last week largely because of a losing bet on drug maker Valeant Pharmaceuticals International Inc., according to people familiar with the matter. A Pershing Square spokesman declined to comment on the Illinois exit or performance.

Plenty of big institutions are still keeping money in hedge funds, as managers promise protection from an economic downturn. But longtime investors are increasingly frustrated about losses that intensified when markets turned more volatile over the last year.

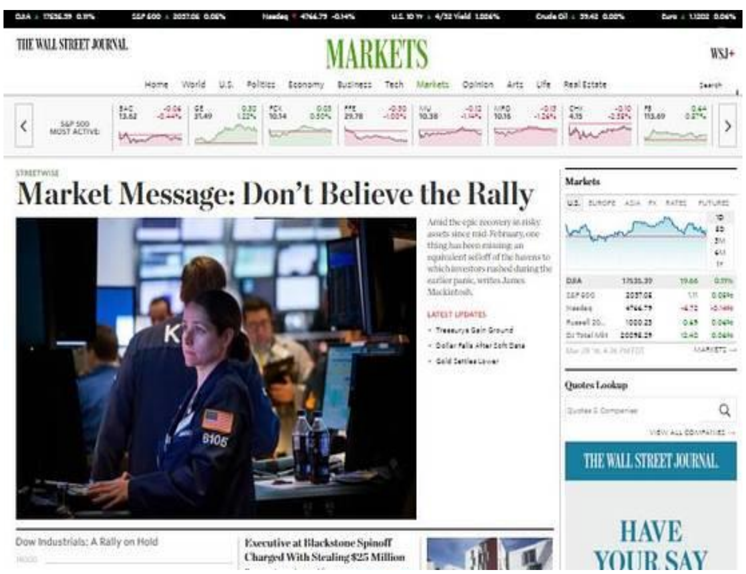
[American International Group](#) Inc. said last month it would cut the $11 billion it had earmarked for hedge funds in half. Citing poor performance by those investments, the insurer said it would reallocate the money to more straight-forward bonds and commercial mortgages managed internally instead.

Others are retreating because some of the investment strategies once available only at hedge funds can now be purchased at a fraction of the cost from other asset managers. These products, coined “liquid alternatives” or "multi-asset,” can make bets on low volatility or the direction of interest rates without using as much leverage, or borrowed money, to supercharge returns.

Hedge funds typically charge higher fees than other money managers, historically an annual 2% of assets under management and 20% of profits. Some new competitors say they offer similar techniques for less than 1% of assets and a zero cut of any profits.

[Northern Trust](#) Corp., for example, charges a management fee of less than 1% for a new “engineered equity” product that it says is similar in approach to a hedge fund. It uses models—instead of traders—to bundle together stocks that limit volatility or market risk, said Mike Hunstad, head of quantitative research for the Chicago-based firm.

The proliferation of lower-price alternatives is one reason the Illinois Municipal Retirement Fund decided last month to end its $500 million hedge-fund program.



The commitment was expensive, said Dhvani Shah, the plan’s chief investment officer. “So do I really want to scale up?” she said. "The answer is no.”

Overall, big investors pulled an additional $19.75 billion out of hedge funds in January, according to eVestment. That was the largest outflow for the year’s first month since 2009. Clients added $4.4 billion in February, but that was well below the $22.6 billion average for that month from 2010 to 2015, eVestment said.

It is too soon to know if those dismal showings will persist. Plenty of big investors still have huge sums committed to the industry.

Endowments and foundations, for example, cut their investments in hedge funds last year for the first time since Wilshire Trust Universe Comparison Service started tracking the data in 2001.

Yet the asset class still accounted for 8.62% of their portfolios through Dec. 31, according to Wilshire.

Hedge-fund commitments as a percentage of U.S. public pension-plan portfolios have dropped from a peak of 2.31% in 2012 to 1.37% at the end of 2015, according to Wilshire.

One hedge-fund manager, TIG Advisors President Spiros Maliagros, said he believes investors will continue to seek out firms like his for the chance to do better than they would with mainstream investments. But he said the industry needs to be clearer that returns aim to diversify and ease the impact of market swings, not simply earn the highest payouts.

“It’s an expectation setting that I think we need to do a better job of,” he said.

The board that oversees Florida’s public pension money, the Florida State Board of Administration, has $3.9 billion invested in hedge funds and no plans to reduce the commitment.

“Our objectives have been met,” said Ash Williams, a former hedge-fund executive who now runs the Florida board.

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—AQR Managing Principal Clifford Asness

Hedge-fund managers are seeking new ways to quiet any investor unease. Some are now pitching their own lower-cost products that bear little resemblance to the industry’s traditional offerings in price.

AQR Capital Management is among the large hedge-fund firms that now offer cheaper alternatives to their main funds. The California Public Employees’ Retirement System, the nation’s largest public pension, has kept $578 million invested with AQR in a lower-cost product that relies on automated bets even as it announced an exit from all hedge funds in 2014.

“It’s been priced as if it was all super special,” said AQR Managing Principal Clifford Asness. “There is stuff still out there sold as magic, but there are simpler, cheaper options that accomplish much of the same thing.”

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